State of Montana
Office of the Legislative Auditor

Performance Audit

DEPARTMENT OF REVENUE

Liquor Division

This report contains recommendations for changes in the liquor related laws and for improvements in the operations and management of the State's liquor merchandising system, including:

- Clarification of the mission of the liquor merchandising program.
- Deposit of interest on idle cash.
- Reduction of inventory levels.
- Changes to improve the profitability of the liquor merchandising system.
- Enhancement of the liquor merchandising administration.

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82-11P

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December 1982

The Legislative Audit Committee
of the Montana State Legislature:

This is our performance audit of the Department of Revenue, Liquor Division. A summary of the audit begins on page S-1.

This report contains recommendations for changes in liquor related laws and for improvement in the management and operation of the liquor merchandising activities of the department. The Department of Revenue response is contained beginning on page 46.

We wish to express our appreciation to the director and the staff of the department for their cooperation and assistance.

Respectfully submitted,

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OFFICE OF THE LEGISLATIVE AUDITOR

PERFORMANCE AUDIT OF THE LIQUOR DIVISION OF THE DEPARTMENT OF REVENUE

SUMMARY

This report is the result of our performance audit of the Liquor Division of the Department of Revenue. Our audit focused on the liquor merchandising system and did not address liquor licensing.

Chapter I explains the organization and scope of the audit and describes how the audit was conducted.

Chapter II presents a brief description of the liquor merchandising system. We describe the division's organizational structure and the functions of each part of the division. The chapter includes a discussion of how other states regulate the liquor industry as contrasted to Montana.

Chapter III covers the division's liquor inventory management system. We noted that the division has over $600,000 in excess inventory.

Part of the reason for this excess inventory is that the division does not give store managers an incentive to control inventory. We suggest the division include inventory control as part of its criteria for awarding bonuses to employees.

Another cause of excess inventory is the way the division distributes newly listed items. These items are stocked in the 40 top selling stores. However, we believe testing in a smaller number of stores would reduce the risk of having large quantities of an item which does not sell well.

The division receives information on its inventories and sales 30 to 45 days late. This lack of timely information may contribute to excess inventories. We suggest the stores report more often and the division speed up the processing of these reports.

Current store ordering procedures do not attempt to minimize inventory costs. Store orders tend to be smaller and more often than necessary which results in increased costs.

Licensees may purchase from any store, thus, all stores must be ready to supply any order. Assigning licensees to stores could reduce inventories by giving store managers better information about who will be ordering what items and what amounts. Legislation would be necessary to implement such a system.

Chapter IV discusses the profitability of the liquor merchandising system. Our concerns related to the profitability of some stores, the profitability of some items, and the profitability of special orders.

When the division is analyzing a store for possible conversion to an agency store, the reasons behind the store's poor performance are not defined. We believe an analysis of these reasons could reveal ways to make the store profitable.

We noted several stores which are not profitable to the state. The division could follow the direction of the 1981 Legislature, close these stores, and thereby increase state revenues.

The division does not analyze the profitability of individual product items. Some items on the product list are probably not contributing to the state's liquor profits. We believe the division should identify such items. Once identified, unprofitable items

should be dropped from the product line or the division should increase the markup on those items so they are profitable.

Items which are not on the product list may be specially ordered without restriction. We believe special orders should be restricted to case lots and the customer should be required to pay some or all of the purchase price when the item is ordered.

In Chapter V, we discuss ways of improving the administration of the liquor merchandising system. Our first suggestion concerned the district supervisors. We believe stationing the eastern district supervisor in Billings could save money. Whether or not the division decides to station the eastern district supervisor in Billings, travel to and from Billings should be by commercial aircraft to save money.

We noted deficiencies in the management information system of the division. The division has decided not to update this system until their point-of-sale reporting system is operational. We believe the division should be updating its management information system concurrently with the point-of-sale system tests.

The division has developed operating manuals for its stores but does not have a written manual for its central functions. We suggest that a written manual could be useful for communicating policies and procedures.

Our review noted that time-of-day sales information is recorded manually with little verification. Since the information is used to decide store hours, we believe it should be collected in a verifiable manner.

Montana law requires the division to apply tax stamps to liquor bottles. The division spends about $100,000 per year applying the tax stamps, but the controls over the stamps are weak. Therefore, we suggest either the controls be strengthened or the requirement be discontinued.

The last chapter discusses legislative improvements which could assist the liquor merchandising system. A major improvement would be to clarify the mission of the division. The Legislature has given the division confusing signals as to whether it should operate as a service organization or a profit-making business. We believe the Legislature needs to statutorily define the division's role.

The liquor merchandising appropriation could be improved. The current requirement to return a fixed dollar amount to the General Fund is probably not realistic given the constraints placed on the division and the state of the economy. It may be better to require the division to return a percentage of its sales.

The current system does not give the division's management an incentive to reduce excess inventory. Since interest on the division's idle cash goes to the General Fund, the effect of excess inventory does not appear on the division's operating statements. Crediting the interest on the idle cash to the Liquor Revolving Fund would not materially change the General Fund but would give the division incentive to reduce inventories.

CHAPTER I

INTRODUCTION

In conjunction with our regular financial/compliance audit of the Department of Revenue, we conducted a performance audit of the Liquor Division. This audit resulted from concerns noted in this and previous financial/compliance audits of the department and from questions about the division's activities voiced by legislators.

The Liquor Division has two major functions. One function is to operate the state's merchandising of liquor. The second function involves regulating private individuals and firms involved in the liquor industry.

ORGANIZATION OF REPORT

This report is presented in six chapters. Chapter I presents an introduction to the report and summarizes the objectives and scope of our performance audit.

Chapter II presents background information on the operations of the division. Included is a discussion of how the state's liquor merchandising system functions.

Chapter III examines the inventory controls of the Liquor Division and includes recommendations to improve controls over inventory.

Chapter IV presents information about the profitability of the state's liquor merchandising system. Included are recommendations to improve the profitability of the Liquor Division.

Chapter V discusses possible improvements in the administration of the Liquor Division.

Chapter VI examines possible legislative changes which could improve the management of the Liquor Division, including a recommendation for the Legislature to clarify the mission of the division.

OBJECTIVES OF AUDIT

The objectives of the audit were to determine if the department is managing and using its resources economically and efficiently and to identify the causes of inefficiencies or uneconomical practices. The audit includes recommendations to the Legislature and to management concerning needed improvements.

SCOPE OF AUDIT

The audit focused on the effectiveness and efficiency of the state's liquor merchandising system. Also included was a limited review of liquor licensing. The audit was conducted in accordance with generally accepted governmental performance auditing standards. We did not find any indications that the department was not in substantial compliance with the laws and regulations related to the economy and efficiency of the liquor merchandising system.

During the audit, we visited stores and reviewed the activities of district supervisors in the field. These visits included discussions with store managers and reviews of the procedures used in the stores.

At the headquarters office in Helena, we examined division policies and procedures, management reports, and internal staff meeting minutes. We interviewed division employees and discussed liquor merchandising issues with the Montana Tavern Association. A sample of stores and of liquor items in the stores was reviewed

to analyze inventory levels. We surveyed the other states which wholesale and retail liquor and reviewed the laws of the states which only license the liquor industry.

The audit concentrated on the merchandising function and did not encompass the liquor licensing system. We did not test the controls over computer applications used in the merchandising operation nor review the financial status of the division. The financial/compliance audit of the Department of Revenue discusses computer application controls and the financial status of the division.

CHAPTER II

BACKGROUND

After the end of prohibition, the federal government left to each state the option of wholesaling and retailing liquor, as well as licensing the industry (control system) or of simply licensing the liquor industry. Montana, along with seventeen other states, opted for a control system. The other 32 states only license the industry.

Originally, liquor controls in Montana were administered by a board. Under Executive Reorganization, the controls were transferred to the Department of Revenue (Liquor Division).

LIQUOR DIVISION

The Liquor Division administers the controls through the four bureaus discussed in the following sections.

Stores Bureau

The Stores Bureau administers the retail merchandising of liquor and wine to individuals and licensees. As of October 1982, the state maintained 143 stores which sell liquor and wine. Sixty-nine of the stores were operated by state employees, with the remaining 74 operated by agents.

The state stores are classified based on sales volume. This classification indicates the number of and pay for the employees. The number of employees per store varies from 1 to 7, with 167 total full-time equivalent employees (FTE) in the state stores.

The state contracts with agents to operate some liquor stores. Under the contract, the state owns the inventory and pays the agent 10 percent of the adjusted gross sales. (Adjusted gross

sales are the total sales minus discounts.) In return, the agent manages the store, pays employee wages, and pays for the facility. Generally, the division converts state stores to agency stores when the division believes the store would be more profitable to the state as an agency store. These conversions occur only when a store lease has expired or a store manager has left employment with the division.

The Stores Bureau also employs four district supervisors. They are responsible for reviewing the activities of the stores in their respective parts of the state.

<u>Purchasing Bureau</u>

The Purchasing Bureau buys the liquor and wine for the state and arranges for its shipment to the state's warehouse in Helena. The bureau has 4 FTE which review reports on trends in orders from the stores and the inventory in the warehouse. From their review, they place orders to the suppliers. Order sizes are adjusted so that full truckloads can be used.

The control states, through their national association, obtain standard quotations from the liquor and wine suppliers. These quotations do not vary whether a state purchases one case or one thousand cases. The only difference in cost between states is the cost to ship the item from the supplier to the state's warehouse.

The Purchasing Bureau also handles special orders. Individuals or licensees may request items not regularly stocked by the warehouse or the stores. The bureau reviews product lists to determine which supplier handles the item. The order for a special item is combined with a regular order, if possible.

Warehousing Bureau

The state maintains a central liquor warehouse in Helena. Shipments from the suppliers come to the warehouse and are unloaded by the bureau's 12 personnel. As orders are received from the stores, bureau personnel accumulate the items for shipment.

The division has contracts with common carriers to distribute liquor to the stores. Trucks so used only carry liquor for the division. When a group of orders are ready for delivery, the warehouse personnel load the common carrier's truck. The liquor is transported to the stores and unloaded by store personnel.

Licensing Bureau

The remaining segment of the division regulates the private firms which sell alcoholic beverages. The following illustration lists the types of licenses issued and the number of licensees.

ALCOHOLIC BEVERAGE LICENSES
(Fiscal Year 1981-82)

Type	All Beverage	Beer	Wine	Beer/Wine
On Premise	1,359	78	-	270
With Catering	36	-	-	-
Off Premise	-	315	203	619
Veterans' Organization	56	-	-	-
Fraternal Organization	68	1	-	-
Airport	-	-	-	4
Distributor	-	21	9	27
Distributor's Subwarehouse	-	4	2	3
Resort	8	-	-	2
Floater[1]	2	-	-	-
Airline	4	-	-	-
Railroad	1	-	-	-
Suppliers, Brewers, Wineries, Manufacturers	-	25	156	-
Vendors	80	-	-	-
Agents	34	-	-	-
Conditional[2]	15	2	-	3
Conditional Floater[1,2]	-	-	-	-
Total	1,663	446	370	928

[1]License in an overquota area which can be transferred to an underquota area.

[2]License which has been approved subject to meeting certain conditions (i.e., meeting fire codes).

Source: Licensing Bureau records

Illustration 1

The bureau's 4.5 FTE are involved in processing the applications for new licenses or transfers and in renewing licenses.

FUNDING

The Liquor Division operates out of a self-supporting (i.e., revolving) fund. Revenues for this fund are generated by the 40 percent markup on each container of liquor and the 40 to 82 percent markup on each container of wine sold by the state. This markup is in addition to the state taxes on liquor and wine which are earmarked for various purposes.

The 1981 Legislature gave the division an unlimited appropriation to fund its merchandising function. However, the division was required to return $13 million in profits to the state's General Fund over the 1981-83 biennium and its operating expenses may not exceed 15 percent of its sales.

In addition to merchandising expenses, some other expenses are paid from the Liquor Revolving Fund. The Licensing Bureau's expenses are paid from the revolving fund with its revenues being deposited directly to the General Fund. The Legislature appropriated money from the revolving fund to finance a portion of Department of Revenue support services such as audit, investigations, accounting, and data processing. These support service appropriations are not related to the actual services received by the Liquor Division. The financial/compliance audit of the department will discuss these issues in more detail.

OTHER STATES

To determine how other states operate their liquor systems, we contacted the other 17 control states and reviewed the statutes of the 32 license states. The following sections briefly discuss our findings.

Control States

Of the 18 control states, 15, including Montana, merchandise liquor through state operated or controlled stores. These other control states include:

--Alabama
--Idaho
--Iowa
--Maine
--Michigan
--New Hampshire
--Pennsylvania
--Ohio
--Oregon
--Utah
--Vermont
--Virginia
--Washington
--West Virginia

In North Carolina, the state's responsibilities include setting retail prices and supervising the private firms which operate the liquor warehouses. The stores are operated by the cities and counties which are required to charge the state-established price.

Two states, Wyoming and Mississippi, operate only on the wholesale level. The state manages warehouses which purchase the liquor and resell it to private firms which operate the bars and stores.

Of the 16 states which establish retail prices, Montana's prices rank in the middle. The following illustration compares retail prices and differences between the purchase price and retail price for an example brand of whiskey. Of the five western control states, Montana has the lowest price and markup on spiritous liquor, including tax.

EXAMPLE OF CONTROL STATE PRICES ON A BRAND OF WHISKEY

State	Retail Price	Percentage Difference Between Retail Price and Product Cost
New Hampshire	$ 8.35	43.0
Vermont	8.45	45.4
North Carolina	9.45	64.3
Virginia	9.45	68.1
Michigan	9.45	72.4
Iowa	9.50	66.7
Pennsylvania	10.04	75.2
MONTANA	10.30	79.1
Idaho	10.30	79.4
Ohio	10.35	82.1
Maine	10.80	85.6
Alabama	10.80	92.5
Utah	10.90	89.6
West Virginia	11.05	90.2
Washington	11.40	96.2
Oregon	11.50	99.0

Source: Compiled by the Office of the Legislative Auditor

Illustration 2

We also compared the control states in several other categories. The results are listed in Appendix I.

License States

The following illustration summarizes the administrative structures, licenses, and taxes of the 32 license states.

SUMMARY OF LICENSE STATE LAWS

Item	Category	Number
Administrative Structure	Independent with a Commission	13
	Independent without a Commission	2
	Department of Revenue	9
	Department of Business Regulation	2
	Department of Public Safety	4
	Local Control Only	2
License Distillers	Yes	32
	No	0
License Wholesalers	Yes	32
	No	0
License Retailers	Yes	31
	No	1
Tax Rate per Gallon on Liquor	\$1 to \$2	2
	\$2 to \$3	18
	\$3 to \$4	4
	\$4 to \$5	6
	over \$5	2

Source: Compiled by the Office of the Legislative Auditor

Illustration 3

CHAPTER III

INVENTORY CONTROL

A major concern of any merchandising operation is inventory management. This chapter discusses our analysis of the division's inventory control systems. We address concerns related to inventory management and recommend improvements. Included is a discussion on incentives for improved inventory control by the store managers, a test marketing system for new products, more timely reporting, and the designation of specific stores for licensee use.

ANALYSIS OF DIVISION INVENTORIES

Our observation of year-end inventory procedures indicated excess inventory may exist in the liquor stores. Previous audit reports also contained recommendations relating to the problem of excess inventory.

Money invested in excess inventory plus the associated storage and handling cost could be invested to increase total revenues of the state. We used sampling techniques to determine the amount of excess stock, if any, and to isolate where the excess was located.

The division divides the state stores into six grades, grade 7 through grade 12, based on sales volume. We took a random sample of state stores from each grade category and a sample from the agency stores. For each store, we selected 20 inventory items at random. For these 20 items we ran an Economic Order Quantity (EOQ) model to determine the EOQ and the reorder point for each

item. EOQ is an inventory management tool which minimizes inventory cost. The EOQ plus the reorder point amount was compared to existing stock. Any inventory level greater than this amount was deemed in excess. (EOQ is discussed in more detail on page 17.)

A statistical evaluation of these items and stores indicated the excess inventory for all stores is at least $560,600 as compared to $6,748,603 total inventory or over 8.3 percent. The excess inventory by store type is listed in Illustration 4.

ESTIMATE EXCESS INVENTORY IN ALL STORES

Store Category	Total Inventory	Minimum Excess	% in Excess
Grade 12	$1,832,512	$ 16,000	.9
Grade 11	1,653,268	231,000	14.0
Grade 10	901,718	68,000	7.5
Grade 9	500,872	2,600	.5
Grade 8	204,069	33,000	16.2
Grade 7	335,651	110,000	32.8
Agencies	1,320,513	100,000	7.6
Total Stores	$6,748,603	$560,600	8.3

Source: Compiled by the Office of the Legislative Auditor

Illustration 4

We randomly selected 50 items from the warehouse inventory list to statistically evaluate the excess inventory present in the warehouse at June 30, 1982. We again ran the EOQ model to determine the proper inventory level and compared it with the actual level to determine excess.

A statistical evaluation of these items indicated an excess in the warehouse with a minimum value of $48,000 as compared to a total inventory of $3,273,953, or about 1.5 percent. This indicates

that the ordering procedures currently used by the department, the Warehouse Requirements Program, adequately controls inventory levels in the warehouse.

The division has unnecessarily invested at least $608,600 in inventory. As a comparison, if the money had been invested at the average short-term investment pool rate (13.8 percent) for fiscal year 1981-82, $84,000 in interest would have been earned.

INCENTIVES FOR IMPROVED INVENTORY CONTROL

At the present time, the Liquor Division provides little incentive to the store managers to control the levels of inventory. This section discusses a possible incentive system to reduce the excess inventory in the stores.

Since 60 percent of all store sales are to licensees, the store managers' primary concern regarding inventory is to assure they meet the demands of the licensees. Store managers tend to order excess stock because the incentive is to make sure the store has a product when the licensee requests it.

During our telephone survey with the other control states we found Vermont's incentive system for store personnel is based heavily on proper inventory control. Proper inventory control is defined as the lowest amount of inventory possible without stock shortages when filling the usual orders.

A common measure of inventory control is merchandise turnover ratios. Merchandise turnover is a measure of how many times a year a store sells its average inventory on hand, as illustrated by the following example.

Monthly Sales	Inventory Balance
1,978	6,070

$$\frac{6,070}{1,978} = 3.068 \text{ months sales in inventory}$$

$$\text{Turnover} = \frac{12 \text{ months}}{3.068} = 3.91 \text{ turnovers per year}$$

We reviewed the turnover ratios for a state store in each grade and one agency store. This review indicates that four turnovers a year is near the average. Our discussions with division officials and officials in other states indicated that twelve turnovers per year are ideal.

The division has an agreement under its union contract to provide a bonus to store employees based on increased productivity. Increased productivity is defined as selling more units per man hour worked. If the productivity measure increases by 10 percent in a quarter, the employees in that store receive a bonus of 5 percent of their base salaries for the quarter. Discussions with division officials indicate that the bonus has increased productivity but future increases in productivity will probably be minimal.

Because the present bonus system does not provide an incentive for inventory control and the current productivity criteria has served its purpose, we suggest that the division consider supplementing the productivity criteria with a measure of inventory turnover. The bonus system should contain a factor for keeping the inventory at a minimum while also maintaining a low number of stockouts. (One or two percent stockouts is probably reasonable.) By establishing incentives for store managers to control the level

of inventory, the division could experience a significant savings in cost for merchandise.

RECOMMENDATION #1

WE RECOMMEND THE DIVISION INCORPORATE CRITERIA FOR INVENTORY CONTROL INTO ITS BONUS SYSTEM.

TEST MARKETING

Before a liquor item is routinely stocked in the state stores, it must be listed by the division. New items are listed based on presentations made by industry representatives. However, the division has little information on how the new items will sell because it has no sales history. The division does not do any preliminary research or test marketability before an item is listed.

After an item is listed, the division stocks it in the top 40 stores (in terms of sales) to obtain sales data for the item. New items that do not sell inflate the inventories of those stores where they were introduced.

While the present system is similar to test marketing, a formal test marketing system for new items could be beneficial. The division could identify a smaller sample of stores that would represent the stores in the system. A probationary period of six months to a year could be established. The division could set sales criteria (i.e., the level of units to be sold during this period) before the item is listed. During the probationary period, the item would be stocked in the test stores and would be available to the entire system on a special order basis. If the item meets

established sales criteria, then it would be listed for general distribution.

A test marketing system should allow the division to order fewer cases of new items and thus keep from inflating the overall inventory with items that are not selling. Therefore, we believe the division should establish a formal test marketing system.

RECOMMENDATION #2

WE RECOMMEND THE DIVISION DEVELOP A FORMAL TEST MARKETING SYSTEM FOR NEW ITEMS.

TIMELY REPORTING

Currently, sales information is reviewed on a quarterly basis and inventories are sent in monthly. The division is operating with a management information system which gives them information that is consistently 30-45 days late. Because of untimely reporting, the division's management and the store managers do not know the sales or inventory of individual items in each store. To effectively control the inventories at each store, sales and inventory figures should be available for review by the division's management, district supervisors, and store managers in a timely manner. To meet this goal, sales information needs to be reported daily (in the ideal case) or at least weekly, and a summary report should be available for management use soon thereafter.

The division is currently testing a point-of-sale (POS) reporting system which it hopes to implement in the higher volume stores,

perhaps as many as 40 stores. The POS system would use computer equipment to record sales as they are made. POS would allow daily sales reports.

While POS may assist in solving the reporting problem, the division still needs to implement a reporting system for the remaining stores which will make timely sales information available. The division could use its current automated cash registers to report daily information for some stores. For the smallest stores, weekly manual reports may be sufficient.

In addition to having more timely reporting of sales by the stores, the division needs to have the sales information summarized soon after it is received. To do so, the division should work with the department's data processing personnel to develop a system which will process the sales data and prepare summary reports. For the larger stores, the summary reports should be ready within two days of receipt of the sales information, while up to a week may be acceptable for the smaller stores.

RECOMMENDATION #3

WE RECOMMEND THE DIVISION IMPLEMENT A SYSTEM FOR REPORTING STORE SALES ON A TIMELY BASIS.

ORDERING SYSTEM

The division does not use an ordering system which minimizes ordering and inventory costs. Current store ordering and warehouse ordering procedures do not consider the cost of placing an

order or the costs of carrying an item in inventory when determining the amount of an order, either by the warehouse or by a store manager.

An economic order quantity (EOQ) system and its application for the warehouse and the stores is discussed in the following sections.

Economic Order Quantity

Economic order quantity (EOQ) is the most widely used ordering method for inventory management. Under an EOQ system, the total cost of inventory is minimized when ordering at the EOQ level. The total cost of inventory includes the costs of placing an order and the costs of carrying the inventory. We used EOQ to evaluate the present ordering systems of the warehouse and the stores.

Warehouse Ordering

In the warehouse ordering process, the Purchasing Bureau chief reviews a warehouse requirements printout and determines how much of each product to order from the supplier. The printout lists current warehouse inventory, items on order, and forecasted demand. Once the amount to be ordered has been determined, Purchasing Bureau staff and the data processing support personnel process the order.

We compared actual order sizes with what EOQ would have indicated. The actual orders were larger than the EOQ amount. However, there is justification for this apparent over-ordering. To get the least expensive freight rates, the division must order in full truckload or railcar lots. They order some additional stock

to fill the truck or railcar. From our analysis, we determined the current warehouse ordering process is adequate.

Store Ordering

The store ordering process involves the store's manager visually going through his stock and reviewing sales history data to determine how much of each product to order. Once the amount to be ordered has been determined, it is sent to the division's Stores Bureau and then to data processing support personnel for processing. We estimated the cost of placing a store order by valuing the time of each individual involved in the ordering process.

The store's carrying costs include estimates of storage costs, handling costs, employee benefits associated with the handling costs, the loss of interest earnings due to carrying the inventory, and insurance on the merchandise.

We computed the EOQ for a sample of six products in six stores. Based on our results, these stores are not ordering at a level which would minimize the total cost of inventory. All stores in the sample are ordering less than the EOQ level. Stores are placing orders of smaller quantities more often than is necessary. Because stores are placing more orders than is optimal, the division's overhead and inventory costs are increased.

To correct this problem, the division has proposed equipping its larger stores with point-of-sale (POS) equipment. (POS uses computer equipment to record sales as they are made and thereby keep better track of inventory.) As of November 1982, the division will be installing the first POS system in one of its larger stores for testing. After the test period, the division will decide whether

to install POS in any additional stores and, if so, in how many stores POS will be installed. For each additional store on the system, the division will spend about $13,000 to $24,000 for equipment, depending on store size.

For the smaller stores, the division is considering hand-held inventory devices similar to those used in some private retail stores. The devices would be used by store personnel to record inventory more efficiently.

While these two systems would provide better information on inventories, they do not provide for ordering quantities which minimize inventory cost. Whether or not the division implements POS and hand-held inventory devices, they should develop a system which uses inventory amounts, sales history, and cost data to minimize the cost of ordering and carrying inventory.

RECOMMENDATION #4

WE RECOMMEND THE DIVISION DEVELOP A STORE ORDERING SYSTEM TO MINIMIZE INVENTORY COST.

DESIGNATED LICENSEE STORES

Currently, 60 percent of the division's business involves purchases by licensees. The nearly 3,000 licensees may purchase their liquor or wine from any liquor store in the state.

During our discussions with other states, we noted that five other states require licensees to purchase from assigned stores. We discussed this idea with department officials and they indicate such a system could have a positive impact on their inventory

situation. They believe store managers carry some additional inventory rather than not being able to fill a licensee order.

An assigned store system would allow store managers to better plan their inventories. One option for an assigned store system would be to have the licensees in a community choose the store they wish to go to and then require the licensees to purchase only from the selected store. Under this plan, the store managers in multi-store cities would know what licensees they would be serving and approximately what to expect them to order.

For a second option, one store could be assigned to handle licensee sales in multi-store cities. Then only that store would be concerned with stocking for licensee sales. The inventory maintained by the other stores in the city could be reduced since they would not have to order excess stock to meet licensee demands.

In either case, an assigned store system should help reduce the excess inventory we noted in the stores. Current statutes are unclear concerning whether the division may require licensees to purchase from certain stores. Therefore, legislation should be enacted allowing them to establish a requirement that licensees purchase from assigned stores.

RECOMMENDATION #5

WE RECOMMEND LEGISLATION BE ENACTED TO ALLOW THE DIVISION TO ESTABLISH A REQUIREMENT THAT LICENSEES PURCHASE FROM ASSIGNED STORES.

CHAPTER IV

PROFITABILITY

The 1981 Legislature required the Department of Revenue, Liquor Division, to deposit $13 million of liquor profits in the General Fund during the biennium. They also required that unprofitable state stores be converted to agency stores or closed on an orderly basis. These requirements by the Legislature have forced the Liquor Division to analyze the profitability of all the stores in the system. An analysis is done whenever a lease expires or a manager terminates and the profitability of a store is questionable.

We reviewed the procedure used by the division and found several areas where an addition or substitution of procedures would help the division improve profitability. Included in our review were state and agency store profitability, profitability of selected stock items, and special orders.

ANALYSIS OF STORES

House Bill 500 of the 1981 Legislature states "Nonprofitable state stores should be closed or converted to agency stores in an orderly manner. A nonprofitable store is one that shows a net loss or is less profitable than if run at agency store status . . . ."

House Bill 483 of the 1979 Legislature states "It is the legislative intent that nonprofitable state stores be closed or converted to agency stores in an orderly manner. A nonprofitable store is one that shows a net loss or is less profitable than if run at agency store status after reducing gross revenues by all state

excise and license taxes and by deducting therefrom all normal operating expenses, which includes a pro rata share, based on gross sales, of central administrative office expenses."

The following sections discuss the division's compliance with these provisions. Included are some suggestions for improvement.

Reasons for Unprofitability

As noted in the previous section, a feasibility study is now performed on state stores where profitability is questionable. The purpose of the study is to determine if a state store would be more profitable as an agency store. Based on a trend line, future sales are projected. Comparisons are made between profits as a state store and the profits as an agency store. A recommendation is then made on whether to convert to an agency store.

This procedure was initiated in order to carry out the legislative mandate to close unprofitable stores or convert unprofitable state stores to agencies. The procedure fails to consider the possibilities of poor economic times which may improve or of management decisions that could be made to increase the profitability of the store.

We noted one instance in which division personnel decided not to convert a state store because it is located in a timber industry area which had high unemployment. Because business may get better when economic conditions improve, they decided to keep the state store open. This type of analysis is not done routinely by the division.

To assure the state will not be losing profits in the future, the district supervisors should review the reasons for unprofitability as a matter of routine. In addition, the district supervisors

should document this review so division management can consider this information when making a decision concerning the status of the store.

RECOMMENDATION #6

WE RECOMMEND THE DIVISION IDENTIFY AND DOCUMENT, PRIOR TO CONVERSION, THE REASONS WHY STATE STORES BECOME UNPROFITABLE.

Closure of Unprofitable Stores

The 1981 Legislature directed the division to close unprofitable liquor stores. We noted thirteen stores with poor net profits as reported by the division (see Illustration 5). In each case, there is another liquor store within fifty miles and at least one licensee in the community to supply the needs of individuals.

STORE PROFITS

Store	FY 81-82 Profit	Closest Liquor Store (One Way Distance)
Westby	$ 924	26 miles to Plentywood
Harlem	1,351	21 miles to Chinook
Saco	3,334	28 miles to Malta
Fairfield	4,777	16 miles to Great Falls
Opheim	1,403	49 miles to Glasgow
Flaxville	760	23 miles to Plentywood
Victor	6,030	12 miles to Hamilton
Scobey	6,366	41 miles to Plentywood
Drummond	1,491	31 miles to Deer Lodge
Frenchtown	925	8 miles to Missoula
St. Ignatius	2,160	15 miles to Ronan
Ashland	(4,894)	43 miles to Colstrip
Walkerville	1,133	5 miles to Butte

Source: Liquor Division records

Illustration 5

A measure of store profitability is the return on investment in inventory. We compared the division's net profit figures for these stores with possible earnings had the store's inventory been invested at the short-term investment pool rate of 13.8 percent. The results are shown in Illustration 6.

COMPARISON OF PROFIT WITH ESTIMATED EARNINGS

Store	(A) Approximate Average Inventory	(B) Return on Inventory (A x 13.8%)	(C) FY 81-82 Profit	(D) Difference (B-C)
Westby*	$ 9,357	$ 1,291	$ 924	$ 367*
Harlem*	31,007	4,279	1,351	2,928*
Saco	14,986	2,056	3,334	(1,278)
Fairfield	21,939	3,028	4,777	(1,749)
Opheim	9,699	1,338	1,403	(65)
Flaxville*	9,125	1,259	760	499*
Victor	28,686	3,959	6,030	(2,071)
Scobey	38,518	5,323	6,366	(1,043)
Drummond*	13,222	1,825	1,491	334*
Frenchtown*	27,457	3,789	925	2,864*
St. Ignatius*	24,009	3,313	2,160	1,153*
Ashland*	16,288	2,248	(4,894)	7,142*
Walkerville*	49,755	6,866	1,133	5,733*

*The state's revenue would have been greater if these stores were not open.

Source: Compiled by the Office of the Legislative Auditor

Illustration 6

This analysis indicates that the state would have made more money if eight of these stores had not been open during fiscal year 1981-82.

Department officials believe the Legislature wanted them to convert state stores on an orderly basis and not close stores. Based on the language in House Bill 483, we believe the Legislature gave the department clear direction to close unprofitable state stores, not just convert them to agency stores.

RECOMMENDATION #7

WE RECOMMEND THE DIVISION COMPLY WITH THE LEGISLATIVE MANDATE REGARDING CLOSURE OF UNPROFITABLE STORES.

PROFITABILITY OF STOCK ITEMS

As a merchandising operation, the Liquor Division should be concerned with the profitability of its products. Since the division does not calculate these profit figures, we determined the net profit per case for a sample of items. The net profit per case of the sample items and the use of a minimum markup are discussed in the following sections.

Net Profit per Case

Net profit per case is the selling price per case less all actual merchandising costs per case. These costs include the per case delivered cost at the warehouse, merchandising overhead per case, warehousing cost per case, actual shipping cost per case, and the store's operating cost per case.

We estimated the net profit per case for ten items in ten stores located throughout the state. These amounts are included in Illustration 7.

NET PROFITS PER CASE

Item	Stores									
	Billings (#5)	Bozeman (#9)	Glasgow (#24)	Broadus (#40)	Plentywood (#53)	Missoula (#171)	Great Falls (#139)	Kalispell (#195)	Browning (#189)	Philipsburg (#25)
A (500 ml)	$21.69	$24.12	$24.22	$ 7.25	$22.27	$23.20	$24.40	$17.73	$25.71	$ 8.51
B (750 ml)	20.01	21.36	20.74	12.17	19.69	19.99	21.52	17.97	22.11	13.19
C (750 ml)	21.09	22.44	21.82	13.25	20.77	21.07	22.60	19.05	23.19	14.27
D (1.75 liters)	33.87	34.68	34.24	29.33	33.55	34.48	34.78	32.79	35.01	30.23
E (500 ml)	62.73	65.16	65.26	48.29	63.31	64.24	65.44	58.77	66.75	49.55
F (750 ml)	23.25	24.60	23.98	15.41	22.93	23.23	24.76	21.21	25.35	16.43
G (1.75 liters)	40.23	41.04	40.60	35.69	39.91	40.84	41.14	39.15	41.37	36.59
H (750 ml)	.45	1.80	1.18	(7.39)	.13	.43	1.96	(1.59)	2.55	(6.37)
I (1.5 liters)	5.55	6.36	5.92	1.01	5.23	6.16	6.46	4.47	6.69	1.91
J (500 ml)[1]	2.73	5.16	5.26	(11.71)	3.31	4.24	5.44	(1.23)	6.75	(10.45)

[1] This variability is due, in part, to the fact that Item J is bottled in Montana, therefore, the markup is 10 percent less than products bottled out of state.

Source: Compiled by the Office of the Legislative Auditor

Illustration 7

Based on these net profit figures, selected products in several stores are unprofitable or, at best, marginally profitable. The most obvious example is item H in the 750 ml size. It ranges from a $7.39 net loss per case in Broadus to a $2.55 net profit per case in Browning.

The carrying of unprofitable products reduces the total profits that could realistically be achieved by the division. The division should routinely estimate the net profit contribution of a variety of products for various stores. This estimate should use the real costs as described above. The following section discusses unprofitable items.

Department officials commented that on a statewide basis, the calculation would be useful because it would identify possible items for delisting. However, department officials responded that they did not believe the information generated from a store-by-store product analysis would be useful since they set prices statewide. Store-by-store analysis would identify which items are not profitable in certain stores. If the division wishes to increase its profitability, items which are not profitable in a particular store could be removed from stock in that store.

RECOMMENDATION #8

WE RECOMMEND THE DIVISION ROUTINELY CALCULATE THE NET PROFIT CONTRIBUTION OF VARIOUS PRODUCTS USING THE ACTUAL COSTS.

Minimum Markup

The Liquor Division's current markup involves a fixed percentage of the cost of the item. The different markups for distilled spirits and table wines are shown in Illustration 8.

LIQUOR DIVISION MARKUPS

Product	Markup[1]
Distilled Spirits	40%
Table Wines:	
Costs less than $8 a case	82%
Costs $8 to $18 a case	60%
Costs more than $18 a case	40%

[1]The markup for in-state products is 10 percent less.

Source: Liquor Division records

Illustration 8

Once the division identifies those products which are unprofitable it can either drop the item or establish a markup which will make the item profitable. The division was given the authority to establish markups by the 1981 Legislature.

At times, an item which is not profitable cannot be dropped from the product line. The primary examples are table wines. While private wine wholesalers serve parts of the state, many rural areas rely on the state stores to provide table wines. In order to provide the service, the division sacrifices its profitability.

One way to provide the service and yet provide for profitability is to establish a minimum dollar level of markup on all items. If the division believes $5 per case is the minimum markup necessary for any item to be profitable, then it would mark up all

of the items either $5 per case or the current percentage, whichever is greater. In this way, each item will be paying its own way.

Department officials indicated they will not change prices without specific legislative direction. This position is a response to the adverse reaction received in the summer of 1982 when the department attempted to change prices. By establishing a minimum markup which is within the department's current authority, the prices of a few products would increase. However, there would not be a general price increase.

RECOMMENDATION #9

WE RECOMMEND THE DIVISION DROP UNPROFITABLE PRODUCTS OR IMPLEMENT A MINIMUM MARKUP WHICH WOULD INSURE A REASONABLE LEVEL OF PROFITS FOR EACH PRODUCT.

SPECIAL ORDERS

The Liquor Division does not have any restrictions on the ordering of special items. An individual may order any liquor item. There is no requirement for customer assurance that the item will be purchased when it arrives. Also, the person placing the order does not have to purchase the whole case but may purchase only one bottle.

One of the liquor control states we surveyed requires that special orders be in case lots and that a deposit be put down on the order. This set of controls effectively restricts the amount of

excess inventory that could result from the ordering of special items.

The division does not have records on the number of special orders, the number of no-shows, or the amount of excess stock caused by the special orders. Therefore, the extent of any problems in Montana is not apparent. However, the establishment of controls would be a useful preventive measure.

RECOMMENDATION #10

WE RECOMMEND THE DIVISION SELL SPECIAL ORDERS IN CASE LOTS ONLY AND REQUIRE CUSTOMER ASSURANCE OF PURCHASE.

CHAPTER V

DIVISION ADMINISTRATION

The Liquor Division is composed of four bureaus. The Stores Bureau is responsible for the merchandising activities and the operation of all liquor stores. The Stores Bureau is unique because it has four district supervisors periodically visiting each store in the state. The Licensing Bureau is responsible for issuing licenses to liquor and beer retail stores and tavern owners. The Purchasing Bureau monitors the stock in the system and orders merchandise from the distillers. The bureau is also responsible for freight breakages and transportation out to the stores. The Warehouse Bureau works closely with Purchasing and Stores to load orders, arrange shipments out to stores, and handle incoming shipments from distillers.

We reviewed the administration of policies and procedures for all the bureaus. We identified concerns involving the district supervisor system, the management information system (MIS), written policies and procedures, time-of-day sales information and tax stamps.

DISTRICT SUPERVISORS

The district supervisor program was started in July of 1978 to monitor the stores' merchandising effort and train store managers in merchandising techniques, inventory control, and personnel relations.

The district supervisor's duties include:

--evaluating store locations and negotiating store leases for the division;

--transferring excess stock and slow moving items from one store to another;

--evaluating stores;

--analyzing stores for possible conversions or closures; and

--closing stores.

The supervisors each are assigned a district within the state. The districts are divided so that sales volume in each district is approximately equal. The supervisors rotate districts each year.

Our review has established concerns in the stationing of supervisors and travel methods to the eastern district.

Stationing

All the supervisors are stationed in Helena and are assigned vans to drive to and from the stores in their district. The van is used to transfer items between stores and transport excess stock back to the warehouse in Helena.

The supervisor for the eastern district must drive his van five hours from Helena before he reaches the nearest city in his district. This constitutes ten hours of travel time per week for travel to and from the district. While working in the district, a majority of his nights are spent in Billings.

Because of the large distance involved, it would be cost effective to station a supervisor in Billings to work the eastern district. The other three supervisors are more cost effectively stationed in Helena. The division would have realized a savings of over $4,000 in travel expenses and overtime during fiscal year 1981-82 if the supervisor had been stationed in Billings.

If the division were to station a supervisor in Billings, the supervisor could use a Billings store to handle the transfer of excess stock. The supervisor would travel to Helena periodically for supervisor meetings. If the division decides to implement this system, modification of the rotation system for supervisors will be necessary.

RECOMMENDATION #11

WE RECOMMEND THE DIVISION STATION THE EASTERN DISTRICT SUPERVISOR IN BILLINGS.

Travel

As mentioned before, there is significant expense involved in traveling between Helena and Billings for the eastern district supervisor.

Whether the eastern district supervisor is stationed in Helena or Billings, flying the eastern district supervisor to and from Helena would be beneficial. Air fare is over $50 per trip less than the cost of gasoline and extra time spent driving a vehicle.

RECOMMENDATION #12

WE RECOMMEND THE DIVISION FLY THE EASTERN DISTRICT SUPERVISOR BETWEEN HELENA AND BILLINGS.

MANAGEMENT INFORMATION

During our review we identified several concerns with the division's management information system, including:

1. The Liquor Division is experiencing a number of problems with the present system. The timeliness of reports is the largest obstacle. Information for sales and inventory is 30 to 45 days late.

2. Information is not always received in the format that the division can use. For example, the listing of operating and sales information is by store number, not by grade classification. Also, the system does not total the breakages and shortages report so that comparisons can be made.

3. The evaluation of stores and the computation of store bonuses are based on units sold per man hour. The division is not provided with a useful format expressing units per man hour. Therefore, computations and reports are done manually.

Several months ago, the Liquor Division and the data processing support personnel met to consider changes to the Liquor Information Management System (LIMS). While a number of needed changes were identified, the LIMS revision has been postponed until the point-of-sale (POS) system is installed.

POS will be installed and operational in a pilot store in November 1982. The division will observe the operation of this store during a two-month period. Based on the results of the test period, division officials will decide on the number of state stores (probably not more than 40) which will be equipped with the POS capability and what type of ordering system will be used in the other stores. The division plans to install the entire POS system over a two-year period (fiscal years 1982-83 and 1983-84).

A revamping of the LIMS should enable the division to operate more efficiently and make better management decisions. Review and revision of the liquor management information system should be implemented immediately.

Department officials stated they do not have sufficient staff at this time to revise the LIMS. The department should have sufficient staff to revise the LIMS if internal priorities are revised. If priorities within the department are not revised, additional staff may be necessary.

RECOMMENDATION #13

WE RECOMMEND THE DIVISION REVISE THE LIQUOR MANAGEMENT INFORMATION SYSTEM IMMEDIATELY.

WRITTEN POLICIES AND PROCEDURES

The division has written operating manuals for state liquor stores and agency stores which provide a detailed explanation of store operating procedures. These manuals are a useful training aid for new store managers and new store personnel, and are a reference source for the current personnel. However, the division does not have a written manual for the central administrative functions (i.e., purchasing, ordering, and warehousing). The following sections discuss two concerns we noted.

Documentation of Training

The formal training that store managers receive should be documented by the division. The store managers should evaluate such training. The informal training that store personnel receive from the district supervisors should be regularly evaluated by the store personnel. These evaluations would provide a basis for determining the effectiveness of various training activities. Without these evaluations, division officials are unable to train and develop staff in the most effective manner.

Documentation of District Supervisor Meetings

The division keeps a record of district supervisor meetings but this record lacks detail and is poorly kept. Division policy regarding the operation of the liquor stores is discussed and established at these sessions. A well-documented record of these discussions should be maintained. Division policy is not communicated clearly within the division and outside the division partly because policy discussions at these meetings are not adequately recorded. Development of a manual would require the division to record and distribute written policy statements concerning decisions made at its meetings.

We believe a written manual which covers staffing, training, and operating policies and procedures for the division is necessary. This manual could include such items as policies as determined at district supervisor meetings, criteria for the closure of unprofitable stores, and criteria for the listing or delisting of products. For the manual to be effective, periodic updates would be needed.

RECOMMENDATION #14

WE RECOMMEND THE DIVISION PREPARE AND PERIODICALLY UPDATE A FORMAL POLICIES AND PROCEDURES MANUAL WHICH COVERS STAFFING, TRAINING, AND DIVISION OPERATIONS.

TIME-OF-DAY SALES INFORMATION

The 1981 Legislature authorized the division to change store hours to increase profitability. The division has attempted to fulfill this mandate by extending the hours of some stores.

Currently, the store manager manually records the hour-by-hour sales on a form. The information gathered through this process is not verifiable.

Liquor Division staff compare the total dollar sales that are recorded by each store manager with the store's wage costs during each hourly period past 6:00 p.m. to determine if it is cost effective to keep the store open during these hours. We found this type of analysis reasonable but determined that a review of the current method of collecting time-of-day sales information and a determination of its reliability should be conducted by the division.

The implementation of the proposed point-of-sale (POS) system could allow the division to verify the accuracy of daily sales information. Until the POS system is operational and for the stores in which POS will not be installed, the division should develop a more reliable method of collecting this sales information.

RECOMMENDATION #15

WE RECOMMEND THE DIVISION REVIEW ITS METHOD OF COLLECTING TIME-OF-DAY SALES INFORMATION AND, BASED ON THIS REVIEW, DEVELOP A MORE RELIABLE METHOD.

TAX STAMPS

Current Montana law requires all liquor bottles to have a Montana tax stamp on the bottle or the bottle may be considered contraband. The primary use of the stamps is to assure that licensees are not selling contraband liquor. During reviews of

licensees, department investigators check that all liquor bottles have the proper stamp. Also, in some cases the stamps can be used to trace stolen liquor.

The Montana tax stamp is similar to a grocery store price label. Store personnel apply the tax stamps to bottles either when the bottles are put on the shelf or when a case of liquor is sold to a customer.

During our review of store operations we noted significant control weaknesses with respect to the stamps, including:

1. Loaning of the tax stamps and applicator gun to a licensee to mark bottles which the store had not marked.
2. Stamping of bottles by a liquor manufacturer's agent.
3. Employees in most stores having unlimited access to the tax stamps and stamping gun.
4. The division not keeping track of what tax stamps were issued.
5. The availability of similar stamps and stamping guns through retail supply stores.

With these control weaknesses, the division has little assurance that the tax stamps are only used in an authorized manner.

An internal department study notes that the cost of applying the tax stamps exceeds $100,000 per year. If the controls over the tax stamps are weak, then the usefulness of this $100,000 expenditure is questionable. We believe the division should strengthen its controls over the tax stamps or the Legislature should discontinue the requirement for tax stamps.

RECOMMENDATION #16

WE RECOMMEND EITHER:

A. THE DIVISION STRENGTHEN CONTROLS OVER TAX STAMPS; OR

B. THE LEGISLATURE DISCONTINUE THE REQUIREMENT FOR TAX STAMPS.

CHAPTER VI

LEGISLATIVE IMPROVEMENTS

The Legislature, through its statutes and appropriations, affects the operations of all state agencies, including the division. During our review of division operations and of other state's systems, we noted several areas in which the Legislature could improve the management of the division. These include defining the division's mission, revising the appropriations for the liquor merchandising function and crediting the interest on the liquor operation cash balance to that fund.

MISSION

During the spring and summer of 1982, the division proposed an increase in its markup on liquor to increase its profits. The division believed that without a price increase they could not meet the legislative profit mandate. The proposal was received unfavorably by the public, who in turn were supported by legislators and thus the proposal was dropped.

The 1981 Legislature mandated the closure of unprofitable stores. However, the division officials interpret this provision in light of comments made during the legislative hearings. The division is under the impression that the Legislature really did not want them to close stores but rather wanted them to continue to convert unprofitable state stores to agency stores.

These examples point to the confusion among division officials about what management direction should be. The 1981 appropriations bill indicates that the division operate as a profit maximizing

business. However, subsequent reactions to division proposals have led division officials to believe they are to act as a service organization.

The Legislature is similar to a board of directors for a private firm. As such, the Legislature needs to give clear direction to the division on how it wants the liquor merchandising system operated. To do so, the Legislature needs to statutorily answer some basic questions, such as:

--Should the division try to maximize profits to the state's General Fund?

--Should the state operate its own or agency stores in each community regardless of profitability?

--Should the state advertise prices?

--Should the state stock a wide variety of products in each store regardless of profitability?

Otherwise, the division will not have direction about what the Legislature wants done, and therefore may not be as efficient and effective as possible.

RECOMMENDATION #17

WE RECOMMEND THE LEGISLATURE CLARIFY THE MISSION OF THE LIQUOR DIVISION.

APPROPRIATION FOR LIQUOR MERCHANDISING

As noted previously, the 1981 Legislature gave the division an unlimited appropriation, provided they met certain conditions. We contrasted Montana's appropriation with the appropriations given liquor control agencies in other control states.

Montana was unique in two respects. Most states give an unlimited appropriation to purchase stock and to pay freight costs but set a fixed appropriation to operate the central administration, warehouse, and stores. The other difference relates to the requirement to return a minimum profit level to the General Fund. Most other state legislatures establish goals for their liquor agencies but do not require a given profit level be reached. The process in the other states involves the liquor agency estimating the profit it can make at given markup levels. The Legislature then selects a desired profit level and the agency tries to reach that profit level using the corresponding markup. There is no absolute mandate to reach the estimated level of profit.

The appropriations system used by these other states seems more realistic given the current constraints on the state's liquor merchandising program. Montana's appropriation law allows the division to close stores and change price levels without constraint in order to reach the mandated profit. However, outside pressure has been applied to keep unprofitable stores open and to keep the division from raising prices.

The division should be given incentive to be efficient and yet the goals established should be realistic. We believe the current method of tying the division's operating expenses to sales is reasonable and gives the division the necessary latitude in their appropriation, coupled with the present profit goal. However, the structure of the profit goal may not be appropriate with the constraints applied to markup and the uncertainty of sales. A better method would be to require the division to return a fixed percentage of sales to the General Fund.

RECOMMENDATION #18

WE RECOMMEND THE LEGISLATURE RESTRUCTURE THE DIVISION'S APPROPRIATION BY SPECIFYING THAT NET PROFIT BE A DEFINED PERCENTAGE OF SALES.

INTEREST ON IDLE CASH

Montana operates with an unlimited appropriation for inventory expense. This allows management to purchase merchandise without restriction on the amount, but provides little incentive for the division's management to control inventory. While excess inventory reduces profits, the real impact on overall profitability is not apparent under the current system.

To be efficient, management needs adequate funds for the purchase of liquor inventory but they also need an incentive to keep the amount of inventory at a minimum. The present system does not provide that incentive. Under current state law, interest on the division's idle cash is deposited directly in the state's General Fund. The division cannot show the interest earnings as profit on the liquor operation.

The Legislature should allow the division to receive the interest on its idle cash. Such a system would serve two purposes. First, the division's management would have incentive to keep inventories low since the interest earnings on moneys not invested in inventory would increase liquor operation profits. Also, price increases could be minimized because the interest would supplement merchandising profits. The proposal does not cost the General Fund money since division profits are eventually transferred to the General Fund.

Implementing this recommendation could reduce the cash flow to the General Fund because the division currently transfers money to the General Fund annually. Any cash flow problems could be mitigated if the division were to make quarterly transfers rather than annual.

RECOMMENDATION #19

WE RECOMMEND THE LEGISLATURE ALLOW THE DIVISION TO RECEIVE THE INTEREST ON ITS IDLE CASH.

APPENDIX I

COMPARISON OF SYSTEMS USED BY STATES WHICH CONTROL LIQUOR MERCHANDISING

State	Wholesale or Retail Controls	Number of Stores: State	Number of Stores: Agency	Number of Warehouses	Warehouse Ordering	Store Ordering	Point of Sale	Licensees Purchase From	Tax Stamps	Days of Week Open	Appropriation System: Operations	Appropriation System: Inventory	Bonus System
Alabama	Both	135	-	1	Computerized	Central	Yes	Certain Stores	Yes	6	Fixed	Fixed	No
Idaho	Both	55	67	1	Computerized	Central	Yes	Any Store	Yes	6	Fixed	Unlimited	No
Iowa	Both	213	-	1	Computerized	Stores	No[2]	Any Store	Yes	6	Fixed	Unlimited	No
Maine	Both	70	54	1	Computerized	Stores	Yes	Any Store	No	6	Fixed	Fixed	No
Michigan	Both	76	-	3	Computerized	Stores	No	Any Store	No	5[3]	Fixed	Unlimited	No
Mississippi	Wholesale	N/A	N/A	1	Computerized	N/A	N/A	N/A	Yes	6	Fixed	Unlimited	N/A
MONTANA	Both	69	74	1	Computerized	Stores	No[2]	Any Store	Yes	5	Unlimited	Unlimited	Yes
New Hampshire	Both	69	-	2	Computerized	Central	No	Store or Warehouse	No	6	Fixed	Unlimited	No
North Carolina	-[1]	-[1]	-	N/A	N/A	N/A	N/A	N/A	Yes	6	Fixed	N/A	No
Ohio	Both	304	127	5	Computerized	Central	Yes	Certain Stores	No	6	Fixed	Unlimited	No
Oregon	Both	2	228	1	Computerized	Stores	Yes	Any Store	No	6	Fixed	Unlimited	No
Pennsylvania	Both	750	-	5	Computerized	Stores	No	Certain Stores	No	6	Fixed	Loan	No
Utah	Both	34	80	1	Manual	Stores	No	Certain Stores	Yes	6	Fixed	Unlimited	No
Vermont	Both	23	40	1	Manual	Stores	Yes	N/A	Yes	6	Unlimited	Unlimited	Yes
Virginia	Both	298	-	1	Computerized	Central	Yes	Store or Warehouse	No	6	Fixed	Loan	No
Washington	Both	182	194	1	Computerized	Stores	No	Certain Stores	No	6	Fixed	Unlimited	No
West Virginia	Both	145	17	1	Computerized	Central	Yes	Any Store	No	6	Fixed	Fixed	No
Wyoming	Both	N/A	N/A	1	Computerized	N/A	N/A	N/A	No	6	Fixed	Fixed	No

[1] The state supervises private wholesalers and the cities and counties operate the stores.

[2] Implementing.

[3] Can be open 6 days per week.

Source: Compiled by the Office of the Legislative Auditor

AGENCY REPLY

DEPARTMENT OF REVENUE

TED SCHWINDEN GOVERNOR MITCHELL BUILDING

STATE OF MONTANA

HELENA MONTANA 59620

RECEIVED
NOV 19 1982
MONTANA LEGISLATIVE AUDITOR

November 19, 1982

Mr. James H. Gillett
Deputy Legislative Auditor
Office of the Legislative Auditor
State Capitol
Helena, Montana 59620

Dear Jim:

Thank you for the opportunity to respond to the Legislative Auditor's recommendations in the Liquor Division Performance Audit report. Our response is attached.

The Division's efforts to improve its performance will be enhanced by the study and the recommendations. I appreciate the professional manner exhibited by your staff while working on the performance audit.

Sincerely,

Ellen Feaver

ELLEN FEAVER
Director

ED/dlk

RECOMMENDATION #1

We recommend the division incorporate criteria for inventory control into its bonus system.

Response

We agree with the recommendation and we will formally include such criteria in our union contract negotiations.

RECOMMENDATION #2

We recommend the division develop a formal test marketing system for new items.

Response

We agree. We will formally list new products in the future only after they have been test marketed in selected stores.

RECOMMENDATION #3

We recommend the division implement a system for reporting store sales on a timely basis.

Response

We agree with the recommendation. The division is presently testing such a system through a pilot store program. The implementation of such a system will be pursued as quickly as time and resources will permit.

RECOMMENDATION #4

We recommend the division develop a store ordering system to minimize inventory cost.

Response

We agree. Such a system is to be included in the overall inventory control and information system referred to in the previous recommendation.

RECOMMENDATION #5

We recommend legislation be enacted to allow the division to establish a requirement that licensees purchase from assigned stores.

Response

We agree. Such a requirement would assist the Division's efforts to enhance inventory control.

RECOMMENDATION #6

We recommend the division identify and document, prior to conversion, the reasons why state stores become unprofitable.

Response

We agree with the recommendation and we will implement it immediately.

RECOMMENDATION #7

We recommend the division comply with the legislative mandate regarding closure of unprofitable stores.

Response

We agree. At the present time the Department is following legislative directives as established during the last session. We will attempt to obtain further clarification from the legislature in the next session.

RECOMMENDATION #8

We recommend the division routinely calculate the net profit contribution of various products using the actual costs.

Response

We agree; however, under current legislative policy we believe that the Department should continue to feature certain products identified as marginally profitable if there is a demonstrated demand for such items in various communities.

RECOMMENDATION #9

We recommend the division drop unprofitable products or implement a minimum markup which would insure a reasonable level of profits for each product.

Response

We will bring this recommendation to the attention of the legislature and seek policy direction from them.

RECOMMENDATION #10

We recommend the division sell special orders in case lots only and require customer assurance of purchase.

Response

We agree with the recommendation and will implement it by July 1, 1983.

RECOMMENDATION #11

We recommend the division station the eastern district supervisor in Billings.

Response

Although the recommendation may have merit, we prefer to initially fly the eastern district supervisor between Billings and Helena to determine the cost savings to be achieved. The consequent savings in time and gasoline may attain a level close to that indicated in the recommendation. If not, the recommendation as stated will be implemented.

RECOMMENDATION #12

We recommend the division fly the eastern district supervisor between Helena and Billings.

Response

We agree with the recommendation and will implement it by January 1, 1983.

RECOMMENDATION #13

We recommend the division revise the liquor management information system immediately.

Response

If Department priorities were revised, general fund revenues could suffer due to inattention to income tax, corporation tax, and resource tax areas. A cost-benefit analysis relating to this recommendation will be completed and submitted to the legislature for their review and consideration.

RECOMMENDATION #14

We recommend the division prepare and periodically update a formal policies and procedures manual which covers staffing, training, and division operations.

Response

We agree with the recommendation and will implement it by July 1,1983.

RECOMMENDATION #15

We recommend the division review its method of collecting time-of-day sales information and, based on this review, develop a more reliable method.

Response

We agree with the recommendation, although to comply with it will require the installation of a point of sale system. Only eleven stores presently have equipment which can automatically record time-of-day sales.

RECOMMENDATION #16

We recommend either: A. the division strengthen controls over tax stamps; or B. the legislature discontinue the requirement for tax stamps.

Response

We agree with part B of the recommendation. The Department has drafted and the Revenue Oversight Committee is sponsoring proposed legislation to eliminate tax stamps.

RECOMMENDATION #17

We recommend the legislature clarify the misssion of the liquor division.

Response

We agree with the recommendation. We will seek clarification in the upcoming session.

RECOMMENDATION #18

We recommend the legislature restructure the division's appropriation by specifying that net profit be a defined percentage of sales.

Response

We agree with the recommendation. We will encourage its adoption by the legislature.

RECOMMENDATION #19

We recommend the legislature allow the division to receive the interest on its idle cash.

Response

We agree with the recommendation as an additional incentive for inventory control.